

An anatomy of interest rates

How interest rates are determined and their impact on our lives



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Interest rate is the price of money and is expressed in percentage; it is the amount a lender charges a borrower. Interest rates are expressed in nominal and real terms, based on the effect of inflation. The nominal interest rate is equal to the real interest rate plus inflation. When a commercial bank borrows from another commercial bank, the interest rate is known as call money rate or call rate. When commercial banks borrow from the Bangladesh Bank (BB) against securities, the interest rate is called policy rate or repo rate. But the rate at which the central bank borrows money from commercial banks is the reverse repo rate. The policy rate is also known as bank rate or discount rate in some countries. In Bangladesh, the bank rate is different from the policy rate and is used for refinancing schemes. Sometimes banks lend money to their special customers with good credit records at low interest rates, which is called the prime rate. Banks also grant loans like a credit limit for a period where a borrower can use the whole fund during said period. But if they fail to use the same, a special interest rate is charged on the unused portion of the loan. This is called a commitment fee. Banks determine their lending interest rates based on the cost of borrowing, non-fund operating costs, margin for default risk, and desired profit margin. When they lend to risky borrowers, they

determine their lending rates by combining risk-free interest rate and compensation for various risks. The risk-free rate is taken from interest rates on treasury bills and bonds, which are risk-free because the government provides the guarantee for their repayment. And a government does not fail or become insolvent as long as it borrows in its own currency. As bills and bonds are issued in the taka, the government has the last resort on printing money to pay financial obligations. After setting the risk-free interest rate, a bank considers compensation for different risks it accepts for lending. The first risk is that of default—that the borrower may not repay the loan in full. If the probability of default is high, the rate of return will also be high. Then comes inflation risk, for which some compensation is estimated. Inflation reduces the banks' real income, that's why, when granting loans, they should consider current and the expected inflation that may rise during the loan term. They must add some premium for this risk. Next, banks keep some margin to compensate for term or maturity risk, which is associated with the length of time until a loan is repaid in full. When a loan has longer maturity, its risk of non-repayment will be greater. If a borrower has easy access to funds when the repayment of a loan becomes due, the loan is

highly liquid. But in absence of such opportunity, the loan may face a serious liquidity risk. A less liquid loan has a greater risk of default. A bank must charge a premium for such a risk as well. Finally, a bank has to estimate compensation for call risk or prepayment risk of a loan. Call risk is the risk that a loan may be repaid in

when the cost of reborrowing funds rises above the returns being earned on investments. Increase in interest rates has a negative effect on banks' profitability. It may increase interest expense and reduce interest income, generating low profits. Profit reduction is a hindrance to capital accumulation; in order to enhance

increased the policy rate by 25 basis points, has further increased the cost of borrowing from the central bank. In such a situation, banks must offer high interest rates to attract deposits. Simultaneously, bank borrowers will have to pay high interests on loans. A number of banks in Bangladesh have been facing a serious liquidity

When interest rates rise, it increases the cost of a project. Thus, it will be difficult to make the project profitable, increasing the probability of loan default. High interest rates also reduce the number of eligible projects. A project becomes viable only when its rate of return is higher than the cost of borrowing. For instance, when the interest rate (cost of borrowing) is 10 percent, all the projects with a return of more than 10 percent are feasible. If it increases to 12 percent, all the projects with return less than 12 percent are now infeasible. Reducing the number of projects is followed by low economic growth. However, investors only accept projects that have a high probability of success when interest rates rise.

An increase in interest rates attracts foreign portfolio investments—investment in financial assets—provided the interest rate differential between two countries is considerable. This also appreciates local currency, making imports cheaper and exports expensive.

If the interest rate rises, it has multiple impacts on the economy. A rise in interest rates will encourage people to save more, creating more inflow of funds in the banks. In contrast, it makes the cost of borrowing more expensive. People borrow less, which results in less demand for goods and services. When the demand decreases, it also decreases the supply. Then producers produce less, requiring fewer workers. As a result, unemployment rises and people spend less. When people spend less, production falls. The overall result is low economic growth—a paradoxical effect. Still, in order to curb the currently prevailing unbearable inflation, a decline in economic growth may be acceptable for a short period.



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full before its maturity. A bank with such unexpected inflow of funds faces reinvestment risk. It may have to reinvest the funds at a rate lower than the previous one.

Interest rate risk happens when unexpected fluctuations decline the value of assets. This risk can be related to reinvestment as well as reborrowing. The reinvestment risk arises when returns on funds to be reinvested fall below the cost of funds. The reborrowing risk, also known as refinance risk, happens

capital, it is necessary to increase profit continuously. Rise in the interest rate also lowers the value of assets since they have a negative relationship. Increase in the interest rate reduces the amount of capital as well, because any loss in the value of assets is adjusted with capital.

Our banks are already facing the interest rate risk as the caps on the rates have been lifted and they are now determined by the interaction between demand and supply. The latest monetary policy stance, which

crisis in the present interest rate regime. Some banks are now offering up to 13 percent interest on deposits. With such a high cost of borrowing, the lending rate must be at least 16 percent to maintain the standard spread—difference between lending and borrowing rates—of three percent. These banks are aggressive because they have acute shortage of funds and want to collect them at any cost. Depositors should not fall in the trap of high deposit rates and they must be cautious about these banks.

With the UNSC ceasefire, Israel is exposed and isolated



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After months of relentless slaughter of Palestinians—in the worst genocide we have seen in recent history—the United Nations Security Council (UNSC) resolution was issued demanding an immediate ceasefire without linking this to any other matter, such as the release of Israeli detainees. This resolution, which bears the number 2728, is a positive development on the US position in particular, as they prevented the issuance of a ceasefire resolution from the UNSC since the beginning of the war in Gaza using the veto. Today, the US position has changed, as it abstained from voting and spoke openly about the resolution being consistent with that of the Biden administration. They did make it clear why Washington did not vote in favour of the affirmative resolution—because it does not provide for “condemnation of Hamas.” Despite some gaps in the resolution, such as providing for a ceasefire in Ramadan, it marks the beginning of a serious shift in the international position.

Israeli Prime Minister Benjamin Netanyahu was angered by Washington's abstention, which shows that he is aware of the dimensions of this international shift against him. He described the US decision to abstain as “a retreat in the position of the United States,” affecting military operations and influencing efforts to release the detainees, according to Netanyahu's office, which led to the decision not to send senior Israeli delegation to Washington, DC to discuss the subject of ground operation in Rafah, which would have been at the request of President Biden.

Netanyahu's stance and reaction to the US administration surprised many and was met with a lot of criticism in both Israel and the US. Some Israeli opposition leaders have accused Netanyahu of damaging the strategic relationship for personal reasons. Senior figures in the US also spoke with the Hebrew website Walla News that Netanyahu chose to create a crisis with the US for domestic political reasons. His reactions are indeed

strange, especially with an ally that has provided voluminous support. Even after the resolution, the Biden administration is reportedly set to greenlight an \$18 billion sale of F-15 fighter jets to Israel.

But if we return to the decision, what angers Netanyahu and many Israelis is not that this resolution will be applied immediately; the US said itself that the



US Ambassador Linda Thomas-Greenfield raises her hand to abstain during a Security Council vote, paving the path for the first successful resolution calling for a ceasefire in the war on Gaza, at the UN Headquarters in New York on March 25, 2024.

PHOTO: REUTERS

resolution is not binding—unlike the majority of countries that consider Security Council resolutions binding and enforceable. Regardless, the resolution has opened the door to very negative changes in Israel's position in the international scene. If Israel ignores the resolution, the UNSC will return to meeting again and adopt more burdensome and more severe

resolutions that may turn into a snowball. The resolution underpins Israel's international isolation and encourages many countries to take sanctions against Israel by stopping the supply of weapons and ammunition and reviewing forms of cooperation. This will undoubtedly create great international pressure on Israel, which has come on the opposite side of the international community and is now being seen as a rogue state.

The Israeli government also believes that the resolution will encourage Hamas to harden its positions and not make concessions in the negotiations. If it will receive a ceasefire free of charge, this means increasing the terms of negotiation or insisting on the demands it makes, especially ending the war, withdrawal of

with the US on the issue of Rafah and the stalled negotiations on the exchange of hostages and prisoners. This should be alarming for the Biden administration. Netanyahu's undiplomatic stance should have consequences and possibly US sanctions.

But on the other side of possibilities, Netanyahu may benefit from the escalation of the crisis with Washington and even from international pressure by marketing himself as the custodian of Israel's interests, the only one who is able to withstand international pressure, including those coming from allies and friends. However, the clash with the US administration will create a rift in the ruling coalition, where Benny Gantz, a member of the War Council and the head of the “official camp,” rejects this policy. The cracks within the Israeli society will intensify the opposition and demands to overthrow his government and go to new elections urgently.

Another problem with the geo-strategic dimensions is the deepening of the rift and disagreement between the Israeli government and Jews in the US, who see Netanyahu as a threat to the idea of the “Jewish-Democratic” state, and view the alliance with the US as one of the pillars of Israel's survival, resilience, strength, and military and economic superiority.

Netanyahu can manoeuvre as an expert in crisis management, but what Israel is going through carries existential risks as it loses its war in Gaza: this large volume of killing innocents, extermination and destruction, raising the ceiling of its cruel goals, and the sheer inability to achieve them by means of war. They say Hamas is destroyed in northern Gaza, but won't let food enter the area. Israel's talking points are talking points to justify a genocide. With each day that this war drags on, Israel also loses its own international status and increasingly becomes isolated. There will come a time when Netanyahu's intelligence may betray him and he will find himself to be the biggest loser on a personal level—and that will be irreversible, causing a major defeat for Israel on the international stage. The state will lose that false aura woven by the Zionist and Western propaganda that portrays Israel as an oasis of democracy, Western norms and values. This process has already begun among international public opinion. The genocidal war in Gaza has exposed, irrevocably, Israel and its falsity.

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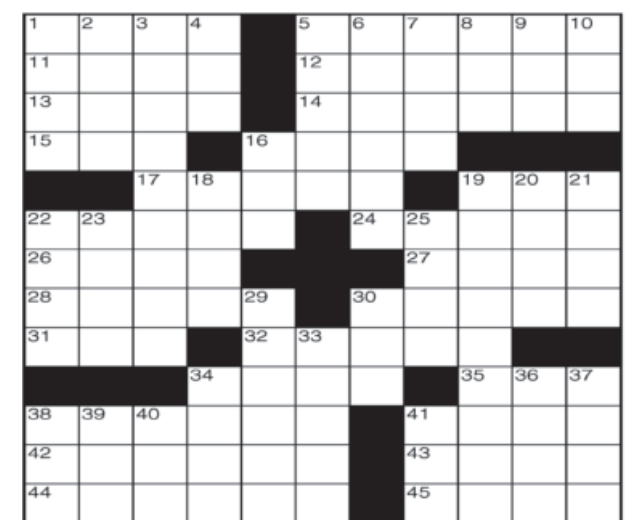
BY THOMAS JOSEPH

Across

- 1 Fly catchers
- 5 Mauna Loa setting
- 11 Realty Unit
- 12 Kampala's country
- 13 Tibia setting
- 14 Need
- 15 “Annabel Lee”
- 16 Londoner, e.g.
- 17 Skirmishes
- 19 Lingerie item
- 22 Burger topper
- 24 Fable ending
- 26 Med. sch. subject
- 27 Puzzle book feature
- 28 Track great Owens
- 30 Corn
- 31 Really impress
- 32 Get smart
- 34 Tailless cat
- 35 Upper limit
- 38 Find not guilty
- 41 Bud's place
- 42 Role for Damon
- 43 Gobi setting
- 44 “Dracula” writer
- 45 High home

Down

- 1 Bee's cousin
- 2 Canyon sound
- 3 Paper carrier
- 4 Capitol Bldg figure
- 5 Step on it
- 6 Illegal hiring practice
- 7 Poet Whitman
- 8 Some amount of
- 9 Chapel reply
- 10 McKellen of “X-Men”
- 16 Outlaw
- 18 Goes bad
- 19 Cranium
- 20 Make fun of
- 21 Out of the wind
- 22 Mexican region
- 23 Over again
- 25 General Bradley
- 29 Galahad's mother
- 30 Upper limit
- 33 Stage direction
- 34 Darkness
- 36 Tag sale words
- 37 Fuel from bogs
- 38 Crunch targets
- 39 Barracks bed
- 40 Status
- 41 Big truck



SUNDAY'S ANSWERS

